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REVIEW OF THE CONTRACTUAL RELATIONSHIPS
BETWEEN THE DEPARTMENT OF WATER RESOURCES
AND LFE, INC.

MAY 1974

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May 21, 1974

The Honorable President of the Senate
The Honorable Speaker of the Assembly
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Members:

Transmitted herewith is the Auditor General's report pertaining to the contractual relationships between the Department of Water Resources (DWR) and LFE, Inc. Such contracts to LFE were awarded in connection with the department's supervisory control systems for the California Water Project.

Two construction contracts in the total amount of \$2,260,900 were awarded by DWR to LFE, contingent on the manufacturing being performed at LFE's Waltham, Massachusetts facility. In fact, LFE assigned performance of the contract to Control Systems Industries (CSI) located in Mountain View, California. LFE owned 49 percent of the stock of CSI at the time of the assignment. This assignment was effected without written consent of DWR and is therefore illegal pursuant to the terms of the contract.

While management personnel at CSI possessed the technical knowledge to perform the contract, DWR's contract terms require that such contracts be awarded to only those companies previously engaged in the manufacture of similar equipment for at least three years prior to the time of the bid opening. This time period requirement was not met by CSI.

The Auditor General has recommended that DWR cease making payments to LFE under the illegally assigned construction contracts and immediately determine the state's rights to recover any monies heretofore paid on these contracts.

The Honorable Members of the Legislature
of California
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With regard to six service (time and materials) contracts awarded to LFE, prevailing wage rates were understated by DWR subsequent to the contract award to LFE, a non-union contractor. Since LFE was the only non-union contractor who bid on the six contracts, it, and it alone, could pay the understated wage rates to its employees, thereby resulting in a windfall to LFE. The Auditor General has recommended that DWR immediately require LFE to pay the actual prevailing wage rates pursuant to the terms of the contracts.

LFE originally failed to qualify for the construction contracts awarded by DWR on the basis of a DWR evaluation team report. Ten days subsequent to this failure, a brother of one of the DWR evaluators was hired by CSI. Two days later, LFE was qualified and was subsequently awarded over \$2 million of construction contracts. The individual on the DWR evaluation team whose brother was the newly hired employee of CSI, with two other DWR employees, formed Macromatics, Inc., as a part-time business venture in addition to their regular state duties. This firm received an approximate \$1,000 payment from CSI subsequent to DWR's first construction contract award to LFE and subsequent to the time that this contract had been assigned to CSI. Further, the DWR employee, whose brother worked for CSI, was involved in the process for approving contract change orders issued to CSI.

The payment from CSI to Macromatics, Inc. is a clear violation of DWR's policy on incompatible activities. Further, the Counsel for the Office of the Auditor General has concluded that such a family relationship, when viewed in light of the change from fail to pass in the contract qualification process of LFE, the payment to Macromatics, Inc. by CSI and the ongoing relationship with regard to change orders, is a circumstance prohibited by the Governor's Code of Ethical Standards.

Complete periodic audits by DWR of the six service contracts with LFE, Inc. have not been conducted. The Auditor General has recommended that DWR immediately conduct such audits and that appropriate settlements resulting from these audits be made.

Respectfully submitted,



VINCENT THOMAS, Chairman
Joint Legislative Audit Committee

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INTRODUCTION

In response to a legislative request, we have reviewed the supervisory control systems for the California Water Project and the relationship between one contractor for such systems and the Department of Water Resources.

The California Water Project is essentially a two billion dollar system to redistribute the state's water. More than 70 percent of California's available water originates in the northern third of the state, while approximately 77 percent of the demand comes from the southern two thirds. The California Water Project consists of a statewide network of dams, reservoirs, generating plants, pumping plants and aqueducts.

To control these facilities, the Department of Water Resources (DWR) has awarded contracts in excess of \$12 million for the design, manufacture, delivery and installation of supervisory control systems. The purpose of the systems is to regulate the various pumps, gates, valves and generators to maintain the required flow of water moving along the aqueduct from Oroville-Thermolito on the north to that portion of the state south of the Tehachapi. The systems also contain monitoring equipment to detect any potential danger conditions and to take corrective action if problems develop.

There is ample documentation available that significant portions of the control systems are poorly designed and poorly constructed, resulting in manual operation of automated systems, overflows, flooding, damage claims against the state, etc.

Since the commencement of this review, the Department of Water Resources has established a task force to evaluate a portion of the system. The report of the task force recognizes many of the problems in the control systems. There is every indication that the recommendations of the task force for the portion studied will be implemented and that the task force will be directed to expand its scope of operation to all control systems.

The one contractor on the control systems which we were directed to review is LFE, Inc. (LFE) of Waltham, Massachusetts, which has two construction contracts totaling in excess of \$2 million and six "time and materials" service contracts.

FINDINGS

CONTRACTS BETWEEN LFE AND THE DEPARTMENT
OF WATER RESOURCES HAVE BEEN ILLEGALLY
ASSIGNED

The Department of Water Resources awarded a construction contract (70-12) to LFE for \$173,900 on July 7, 1970 and on April 14, 1971 awarded them a second construction contract (71-01) in the amount of \$2,087,000.

LFE was prequalified as a prime contractor for DWR on December 19, 1969, contingent on the manufacturing being performed at their Waltham, Massachusetts facility. On July 17, 1970, LFE Corporation notified the Department of Water Resources that "LFE has selected its Control Systems Industries (CSI) group in Mountain View to perform the contract". CSI was incorporated on October 30, 1969 in Delaware and records of the California Corporations Commissioner show that LFE Corporation was issued 49 percent of the stock. LFE obtained an option to merge CSI into LFE. This option, however, could not be exercised less than three years or more than five years from the date of incorporation of CSI. This means CSI could not have been a subsidiary of LFE until at least October 30, 1972.

Section 4L (Contractual Relations of Parties) of the Standard Provision of both contracts states that "the contractor shall not assign performance of work except upon the written consent of Director and in no event shall he assign performance of part of the work". There has been no written consent from the director.

In the opinion of the Legislative Counsel and the Counsel for the Office of the Auditor General, a contractor with DWR may not assign the contract to another contractor without the permission of the Department of Water Resources, and an assignment without such permission is illegal.

DWR has consistently addressed contract change orders to CSI in Mountain View and field inspection personnel have been assigned to their plant facilities on several occasions so there can be little doubt the department knew that work was not being done at the Waltham, Massachusetts facility by LFE, as was contractually required.

While the precise reason(s) for the contract arrangements is not known, the management personnel at CSI did have the technical knowledge to do the job for DWR as such personnel had been previously under contract to DWR while employed by another company on other control system contracts. These people left that company and started their own firm (CSI). The pre-bid qualification requirements of DWR are stringent and a company such as CSI which had only been recently incorporated would not have qualified. Specifically, Section 13A of the special provision of Contracts 70-12 and 71-01 states, "suppliers of equipment to be furnished under this contract shall have been engaged in the manufacture of similar equipment for a period of at least three years prior to time of bid opening". (Contracts 70-12 and 71-01 included in their requirements the manufacture of control systems by the contractor.) The bid opening on Contract 70-12 was June 10, 1970 which was only seven months after CSI's incorporation date. The bid opening date on 71-01 was March 31, 1971 which was 17 months after CSI was formed. The contract specifications would have clearly precluded CSI from bidding on either contract since it was not involved in the manufacture of such equipment prior to its incorporation.

In view of the illegal assignment of the contract to CSI, it is our judgment that payments under the contracts should cease.

RECOMMENDATION

We recommend that the Department of Water Resources cease making payments to LFE under the illegally assigned construction contracts and immediately determine the state's rights to recover any monies heretofore paid on these contracts.

THE DEPARTMENT OF WATER RESOURCES
ERRONEOUSLY UNDERSTATED PREVAILING
WAGE RATES, THEREBY GIVING A WINDFALL
TO LFE, INC., A NON-UNION CONTRACTOR

Six service contracts were issued to LFE, Inc. to perform maintenance on the control systems for the California Water Project on a "time and materials" basis. The contracts were all competitively bid with each firm quoting their respective rate per hour for each class of labor. The agreements contain the clause, "work rules, subsistence, travel time and related activities shall be in accordance with the collective bargaining agreements covering the area and the trade involved".

Although all potential contractors bid on the same thing, i.e., unspecified prevailing wage rates, erroneous prevailing wage rates understated by DWR subsequent to the contract award to LFE resulted in a windfall to LFE.

Since LFE was the only non-union contractor bidding on the six service contracts, and hence the only one able to pay less than prevailing wages to its employees, the erroneous statement of the prevailing wage rates resulted in a windfall to LFE which could not have accrued to any other of the contractors bidding on the contracts.

As an example of an erroneous rate, Contract B50799 called for the services of a journeyman electrician in Fresno County and the prevailing rate given by DWR which LFE was to pay its employees was \$6.50 per hour, including fringes. A publication of the Division of Labor Statistics and Research of

the California Department of Industrial Relations shows that at the time the contract was prepared the rate for journeyman electricians in Fresno County was \$9.75, including fringes. Other rates stipulated by DWR are equally in error for other trades on all six service contracts issued to LFE.

An audit of LFE's payroll records was attempted by the Office of the Auditor General at the company's Santa Clara offices but it was limited in scope because the company had centralized their payroll accounting in Massachusetts as of October 1972 and would not transmit the required records to California for review. LFE did offer, however, to fully cooperate in an audit if the Auditor General's staff would journey to Massachusetts. Such a trip was not made. Payroll records for the period July through October 1972, which were available for audit, revealed that LFE was paying substantially less than the prevailing union rates.

RECOMMENDATION

We recommend that the Department of Water Resources immediately require LFE to pay the actual prevailing wage rates pursuant to the contractual terms.

THE CONTRACT RELATIONSHIPS BETWEEN
LFE, INC. AND THE DEPARTMENT OF
WATER RESOURCES INVOLVE INCOMPATIBLE
ACTIVITIES ON THE PART OF STATE EMPLOYEES

In order for a contractor to bid on work for the Department of Water Resources he must first be prequalified. This consists of a DWR evaluation team visiting the contractor's facilities to see if he has the proper plant, equipment and personnel to do the job. In addition, the contractor submits financial data and a statement of previous experience for review by DWR headquarters personnel. A DWR evaluation team visited LFE's facilities and on December 5, 1969 issued an evaluation report which noted that LFE had failed to qualify as a contractor for construction contracts for all subsystems, including Wallboard Displays.

On December 15, 1969, a brother of one of the DWR evaluators was hired by Control Systems Industries Corporation (CSI) in which LFE had a 49 percent interest. Two days later, LFE was qualified to bid on Wallboard Display Sub-systems. The DWR engineer making the change in LFE's evaluations report could not remember the reason for the change other than that he had been asked to reconsider the failing score by a supervisor in another unit. This supervisor reported to the individual in DWR whose brother was the newly hired employee of CSI.

On May 25, 1970, the individual on the DWR evaluation team whose brother was the newly hired employee of CSI, with two other DWR employees, formed Macromatics, Inc. as a part-time business venture, in addition to their regular state duties. This company was to provide consultant services in the fields of computer systems, information display systems, control and telemetry

systems and telecommunication systems. Records of Macromatics, Inc. reviewed as the result of a subpoena issued by the Joint Legislative Audit Committee disclosed a payment of \$989.68 from CSI to Macromatics, Inc. on September 19, 1970 after the first contract to LFE was let and after that contract had been assigned to CSI.

The DWR employees involved have frequent contact with CSI and LFE in such sensitive areas as vendor pre-qualification, design submittal approval, and change order approval. One of the employees involved has resigned and the other two have issued a statement to the Director of DWR admitting acceptance of the payment but stated that it was for consulting services rendered on their own time on a non-state project. The statement was issued shortly after the subpoena became known to them.

Section 19251 of the Government Code requires in part that:

"A state officer or employee shall not engage in any employment, activity, or enterprise which is clearly inconsistent, incompatible, in conflict with, or inimical to his duties as a state officer or employee or with the duties, functions or responsibilities of his appointing power or the agency by which he is employed.

"Each appointing power shall determine, subject to approval of the board, those activities which, for employees under his jurisdiction, are inconsistent, incompatible, or in conflict with their duties as state officers or employees."

In accordance with this requirement, the Director of Water Resources issued a statement on incompatible activities on July 29, 1966 which states in part that improper business relationships include:

"Entering into, or engaging in, any partnership, profit sharing, employment or other business arrangement with any person who has, or may reasonably be expected to thereafter attempt to obtain, a contract or contracts with, or who sells, or supplies, or services, to the Department. Exemptions from this rule may be granted by the Director in special cases, where the nature of the particular employee's state work is such that it is clearly evident that he cannot possibly influence the amount of business done by such person with the Department."

The Department of Water Resources states that on several occasions they have circulated the statement on incompatible activities to the employees involved. The Director of DWR has never issued an exemption to the employees involved and his first knowledge of the business relationship was the letter of admission delivered to him on August 23, 1973 which was approximately three years after the fact.

The acceptance of the payment is a clear violation of the Department of Water Resources' policy on incompatible activities.

The relationship of CSI to certain state employees is further complicated by the fact that during the time in question, the DWR employee whose brother was an employee of CSI was involved in the process for approving contract change orders. Change orders issued to CSI in excess of \$200,000 have been routed through this DWR employee for approval.

Executive Order 66-2, Governor's Code of Ethical Standards, Article I, states in part, "State officers and employees must avoid all situations where prejudice, bias, or opportunity for personal gain could influence their decisions.

They must equally avoid circumstances suggesting that favoritism or personal gain is the motivating force in the conduct of state government."

In the judgment of the Counsel for the Office of the Auditor General, such a family relationship, when viewed in light of the change in the vendor prequalification for LFE, the payment to Macromatics, Inc. by CSI and the ongoing relationship with regard to change orders, is a circumstance prohibited by the Governor's Code of Ethical Standards.

The Director of the Department of Water Resources stated that the department will immediately commence an investigation of all alleged incompatible activities on the part of the DWR employees and appropriate disciplinary action will be taken where it is justified.

COMPLETE PERIODIC AUDITS BY THE DEPARTMENT
OF WATER RESOURCES OF THE "TIME AND MATERIAL"
CONTRACTS WITH LFE, INC. HAVE NOT BEEN CONDUCTED

The Office of the Auditor General performed an audit of the billings presented by LFE and paid by the Department of Water Resources for the six "time and materials" service contracts issued during 1972 and 1973. The records available at the department's accounting office or CSI's office disclosed that every billing contained one or more of the following errors:

- Mathematical Errors - Numerous billings presented by LFE and paid as billed, contain one or more mathematical errors.
- Missing Engineering Reports - In many cases there was no engineering report in the file to support the claim paid, or there was an illegible carbon copy. Frequently, when a report was present, it did not state what work was performed and/or at which job site.

This report is to be filed daily by the state-employed engineer working at the job site, and is to indicate the work done by the contractor, and what allowable charges the contractor may bill for.
- Incorrect Allowable Charges - Some allowable charges (such as overtime premium, subsistence, mileage, and subcontracting costs) included on the engineering reports and/or employee travel claims: (1) were never billed; (2) were billed at a rate less than the rate allowed in the

contract; (3) were billed at a rate in excess of the amount of the reimbursement paid to the CSI employee; or (4) were billed [and paid] twice.

- Incorrect Service Dates - A review of the employee travel claims indicated that the employees worked on some days that the state was not billed for, and did not work on other days that were billed.

The audit of the contractor's records was limited in that only records from July 1 through October 31, 1972 were available in LFE's Santa Clara facility. After that time, the payroll function was consolidated at their Waltham, Massachusetts facility.

A complete periodic audit of LFE's "time and materials" contracts has never been conducted by DWR auditors. In our judgment, such an audit is mandatory. Appropriate settlements resulting from such audits should be effected.

RECOMMENDATION

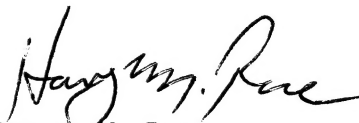
We recommend that the Department of Water Resources immediately conduct a complete periodic audit of all LFE's "time and materials" contracts and that appropriate settlements resulting from such audits be made.

SPECIAL COMMENT

The cooperation of the Director of DWR and his legal staff in the conduct of this review was outstanding.

SUMMARY OF COMMENTS OF
DIRECTOR AND STAFF OF THE
DEPARTMENT OF WATER RESOURCES

1. The Department of Water Resources (DWR) has suspended all payments to LFE Inc., since December 1973, pending completion of the Auditor General's report. DWR will now initiate an investigation of the possibility of improper contract assignment and take appropriate action.
2. A periodic audit program of selected "time and materials" contractors will be studied.
3. Prevailing wage rates issued to contractors will be verified for accuracy before release.
4. The problems described by the Auditor General pertaining to design errors and poor workmanship are isolated instances and should not reflect upon the entire supervisory control system.


Harvey M. Rose
Auditor General

May 21, 1974

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